Mr. Behounek makes other adjustments based on his analysis of Ameritech's budgets, combines his adjustments with those suggested by Dr. Ankum, and by rerunning the Arthur Andersen model develops markups of 5.3925% over TELRIC for shared costs and 6.8887% markup for common costs, for a total markup of 12.2812% over TELRIC for all shared and common costs. (Id., p. 30).

As noted in the discussion of shared costs above, Dr. Ankum made various adjustments which resulted in a percentage of joint costs divided by extended TELRICs of 5.90%. MCI witness Ankum testified that, in his opinion, Ameritech's shared and common costs are overestimated by a minimum of 20%. Based on that statement he develops a markup for common costs of 8.36% over TELRIC. Combining the two markups, he recommends a fixed markup of 14.42% over TELRIC for shared and common costs combined. (MCI Ex. 2.0P, pp. 9, 108, 116-117).

According to AT&T and MCI, an appropriate range, therefore, in which the Commission could choose a combined shared and common cost mark-up is between 10% and 14%.

Ameritech Rebuttal

In response to Dr. Ankum, Ameritech Illinois argues that his proposed initial 20% reduction of the common costs assigned to UNEs rests upon erroneous premises, among other things, his assertions that Andersen relied upon "historical" or "embedded" costs in its analysis rather than "forward-looking" costs, and that Andersen's figures do not reflect efficient operations. Ameritech Illinois contends that the budget process as a key determinant of manager performance evaluation, alternative regulation, and competition forces Ameritech Illinois to be efficient. In addition, efficiency is a TELRIC concept which is conspicuously absent from the FCC's discussion of shared and common costs.

Ameritech Illinois also argued that the facts refute Dr. Ankum's charges that the Andersen study improperly allocated costs to shared and common costs for UNEs, including legal and public policy costs associated with obligations imposed by the Act. In response to arguments that Andersen did not adequately exclude retailing costs, Ameritech Illinois maintains that the FCC Order merely sought to exclude expenses which were directly tied to retailing alone. The question is not whether the cost has some tangential benefit for retail service, but rather whether the cost is one incurred solely for retailing or one that is incurred by wholesalers and retailers alike. Mr. Broadhurst testified that only about 0.3 % of Dr. Ankum's alleged retail costs were allocated to Ameritech Illinois UNEs, which amounts to less than a penny a loop. (AI Ex 4.1 p.14).

Ameritech Illinois also responded to many of the specific expenses to which Dr. Ankum objected. It claims that Dr. Ankum's criticisms of the allocations of AIIS to shared costs is fatally flawed because it relies on an outdated organizational chart which did not reflect the current organization of AIIS or the work currently performed or expected to be performed by AIIS employees. (AI Ex. 4.1 p. 26-27). It says that all the shared costs allocated from Corporate Strategy are directly attributable to unbundling, but even if some of the costs actually were attributable to resale, Dr. Ankum makes no attempt to identify the portion but merely redirects all expenses to common costs. Ameritech Illinois also argues that Dr. Ankum's objections to allocations of legal costs are severely flawed. For example, he fails to recognize that incumbent LECs will continue to incur substantial legal expenses in connection with their unbundling obligations and he has a persistent urge to spread costs caused by new entrants to other customers of Ameritech Illinois in spite of his recognition that costs must be recovered from cost causers. Ameritech Illinois offered a similar response to criticisms of its allocations from the Public Policy department.

Ameritech Illinois argued that there was a good reason for not putting new ventures in a separate cost category: as part of the Corporate organization they do not have their own separate cost structure. Further, Andersen recognized that costs for new ventures should be separated and did so by directly attributing "new venture" costs to non-UNE Corporate activities and excluding them from the allocable Corporate common cost pool. (AI Ex. 4.1, p 22-23).

Ameritech Illinois defended its flat dollar amount markup across loop rate zones as consistent with ¶ 696 of the FCC Order, and charged that Dr. Ankum's proposed use of fixed percentage markups would be conceptually similar to the type of "Ramsey pricing" that the FCC prohibited in that provision. Finally, Ameritech Illinois argued for the reasonableness of its shared and common cost markup by pointing out that Dr. Ankum himself had vigorously supported the Hatfield model in MCI's interconnection arbitrations against Ameritech across the five-state region, which results in a shared and common cost markup in excess of Ameritech Illinois' proposal here.

In response to AT&T witness Henson, Ameritech Illinois argues that there were flaws at each step of his analysis. First, Ameritech Illinois notes that Mr. Henson's attempt to eliminate all retail costs from the pool of shared and common costs actually amounts to a "double-dip," as Arthur Andersen had already excluded all retail costs from the amounts being analyzed by Mr. Henson. Ameritech Illinois also notes that Mr. Henson used a 22 percent figure allegedly prescribed as the weighted average wholesale discount in the Wholesale Order, Docket Nos. 95-0458/0531. In fact, Ameritech Illinois argues, the actual weighted average discount required by that methodology is less than 16 percent. Ameritech Illinois also argues that Mr. Henson's 55 percent figure, which he used to derive his final proposed markup, was improper for a number of reasons, including that it overlooked a large amount of shared and common costs. Finally, Ameritech Illinois maintained that in some circumstances Mr. Henson's methodology could eliminate as much as 88 percent of the shared and common costs computed by Arthur Andersen.

Ameritech Illinois argues that none of Mr. Behounek's suggestions are appropriate. Ameritech Illinois points out that Mr. Behounek's annualized budget is not forward-looking, but based on historical data, that productivity gains are already reflected in Ameritech's 1997 preliminary budget, and that new ventures were appropriately accounted for in the Arthur Andersen study. As a result, Mr. Behounek's adjustments result in an improper reduction in the shared and common costs percentage markups. Ameritech Illinois also points out that Mr. Behounek proposed revisions to software costs which are contrary to Ameritech Illinois' accounting practices and fail to recognize that all the costs are being caused by unbundling activities.

WorldCom

WorldCom criticized Ameritech Illinois' shared and common cost study on the ground that it did not purport to implement the Illinois Cost of Service Rules, codified at 83 Ill. Admin. Code 791. WorldCom argues that if the U.S. Court of Appeals for the Eighth Circuit were to reverse the FCC's authority to establish cost rules under Section 252(d) of the 1996 Act, we would have to apply our Cost of Service Rules; under those circumstances, Ameritech would be required to resubmit its cost studies to make them conform to our Cost of Service Rules.

In response to WorldCom's contention that the Andersen study improperly failed to comply with our Cost of Service Rules, Ameritech Illinois argues that the Cost of Service Rules were designed to establish price floors for retail services, while the TELRIC methodology implemented under Section 252(d) of the Act establishes wholesale prices for unbundled network elements. Accordingly, Ameritech Illinois asserts that WorldCom's criticism is off base because the Cost of Service Rules establish standards different from, and are not relevant to, the standards mandated by Section 252(d) of the Act.

Staff Position

Staff concurs that Ameritech's definitions of shared and common costs are consistent with the FCC's definitions. (Staff Exhibit 1.0, p. 18). However, it was not sure that Ameritech strictly adhered to those definitions when performing its shared and common cost studies and allocations. Staff also recommended that the Commission should recognize that the 1997 preliminary budget data used by Andersen and Ameritech to develop its shared and common costs for UNEs is not forward-looking from an economic sense and, therefore, the basic expenses to be used for determining shared and common costs remain an issue to be decided in this proceeding. (Staff Initial Brief, p. 123).

Staff witness Price also questioned the allocation of shared and common costs developed by Ameritech and Arthur Andersen. The first question he addressed was the appropriate starting point from which to develop shared and common costs, i.e., what sort of business organization budgets should be used at the outset of the analysis. Initially, he believed that commitment budget data would be more reliable than preliminary budget data. (Staff Exhibit 1.00, pp. 19-20). Mr. Price could not determine from data provided if Ameritech's preliminary budget was reasonable, so he requested budget to actual results for 1994 through 1996 in order to make an independent analysis to determine if 1997 preliminary budgets were reasonable. Ameritech Illinois did not provide the data. However, based on expenses for six months of 1996, some of the individual work group forecasts for 1997 appeared reasonable. Forecasted 1997 expenses for AIIS, however, were almost twice the 1996 end of year projection. According to Ameritech, this increase is necessary in order to fully staff AIIS for the work load expected in 1997. However, Staff witness Price concluded that this increase appeared to be excessive. (Id., pp. 23-24). He concluded that an increase ranging between 2.3% and 3.0%, relative to the Consumer Price Index, would be more reasonable. (Id., p. 25).

Mr. Price disagreed with the arguments set forth by AT&T and MCI witnesses in his rebuttal testimony, primarily because the testimony of three witnesses, all representing a joint issue, presented different methods for calculating the shared and common costs. (Staff Exhibit 1.01, p. 8). Mr. Price concluded that Ameritech's cost estimates would overstate UNE costs, while those projected by AT&T would understate them. (Id., pp. 4-5). He maintained that the 1996 annualized budget data is no better than the 1997 preliminary budget, as it is just a mathematical calculation of the year based on 8 months of actual data. Further, since the 1996 budget year is completed, Mr. Price recommends that actual expenditures for 1996 be used as the starting point for calculating shared and common costs for UNEs. There should be no disagreement about the costs, as they can be verified through information available to the public. As testified to by AT&T/MCI joint witness Behounek, some 1996 costs are applicable to the establishment of AIIS, as well as to the implementation of the Act and the FCC Rules. They do not include some of the questionable costs included in the 1997 preliminary budgets. (Id., pp. 7-8).

Mr. Price also questioned the allocation of costs to Illinois using extended TELRIC, as it appeared to assign more costs to Illinois than Ameritech's current "general allocator." The current allocator used to assign corporate costs to Illinois is 24.32%, while the extended TELRIC assigns 32.8% of shared and common costs applicable to UNEs to Illinois. (Id., p. 29).

Mr. Price also generally recommends the methodology used by Arthur Andersen for developing shared and common costs, including the allocation of costs based on extended TELRIC. (Id., p. 10). Mr. Price believes this methodology will approximate "forward-looking, long-run economic costs" by eliminating the large build-up of costs projected for Ameritech in 1997, and will provide a reasonable estimate of shared and common costs applicable to UNEs.

Staff notes that Ameritech provided Mr. Price with the 1997 Commitment Budgets for the four organizations used by Ameritech to develop shared and common cost estimates for UNE pricing. Ameritech Cross, Price, Exhibit 15-P. (Tr., p. 1867). Staff points out that the commitment budgets for AIIS have increased over the preliminary budget by approximately $30 million and the commitment budget for Centralized Services had increased by approximately $164 million over the preliminary budget. In total, the commitment budget was also higher than the preliminary budget. (Id., pp. 1883-1884) Staff believes this makes it even more essential that a different amount be used to determine shared and common costs than either Ameritech's preliminary or commitment views of the 1997 budget. Ameritech proposes to use the preliminary budget, which includes very high startup costs for AIIS and considerable increases in projected Centralized Services costs, to establish costs for UNEs and Interconnection agreements. Staff argues that by using these one-year costs, and a one-year demand figure, it is obvious that prices will be set higher than if Ameritech used a long run estimate (at least three years of data as it currently uses for LRSIC studies) for costs and demand. Using actual cost data from 1996 along with estimated demand for 1997 will alleviate the potential problem for which Ameritech has been accused, that of overstating costs and understating demand with the result of establishing UNE rates that are unfair to its potential competitors.

Staff also proposes that, with respect to unbundled loops, Ameritech's allocation of shared and common costs should be performed on an extended TELRIC basis for each rate zone, rather than a flat dollar amount per loop basis.

In its Reply Brief Staff clarifies that the Andersen methodology is appropriate only if applied to reasonable costs. Staff does not believe that preliminary or commitment budgets are reasonable, because they are forecasted and are subject to change based on decisions not yet made by Ameritech Illinois management. If Staff's proposal is not adopted, then Staff believes that a shared and common cost markup between 10 and 15% as proposed by AT&T and MCI should be adopted. A standard markup eliminates some but not all of the problems which Staff has with Ameritech Illinois' proposal.

Ameritech Rebuttal

In response to Staff witness Price's recommendation that actual 1996 expenditures be used as the starting point for determining shared and common costs, Ameritech Illinois argues that use of actual 1996 expenditures (1) would not lead to forward-looking shared and common costs as required by the FCC, and (2) would fail to account for any of the changes occurring in the local exchange business and the significant ongoing expenses that Ameritech Illinois must bear to fill its new role as a wholesaler and supplier of UNEs to competitors in the post-Act unbundled environment. Ameritech Illinois further notes that for the first two rounds of testimony, Mr. Price himself supported the use of 1997 "commitment" budgets, as opposed to 1996 figures, as the appropriate method of setting forward-looking costs. Moreover, the 1997 "commitment" budgets initially favored as the starting point by Mr. Price actually turned out to be higher than the 1997 preliminary budgets consistently adhered to by Arthur Andersen in Illinois and other states.

As for Mr. Price's argument that shared costs must be allocated to individual UNEs based on cost causation, Ameritech Illinois notes that Mr. Broadhurst's rebuttal testimony explained that shared costs, though relating only to UNEs, relate to all UNEs in general and not to any specific element. Thus, Ameritech concluded, the only logical way to deal with these costs (e.g., Legal, Public Policy, and AIIS unbundling costs) was to allocate them proportionally among UNEs. Ameritech Illinois also argued that Staff's proposal to allocate shared and common costs to unbundled loops based on the specific TELRIC for each rate zone (A,B, and C) was functionally identical to Dr. Ankum's proposal for allocating shared and common costs to loops and should be rejected for the same reasons.

Commission Analysis and Conclusion

On some of the preceding issues we have faulted Ameritech Illinois for enthusiastically developing its own rather inflated view of "forward-looking" costs, sometimes in disregard of its own actual operations. The Andersen study is in some respects restrained in comparison. For example, we think a reasonable interpretation of the FCC Order is that shared and common costs attributable to UNEs should be identified on a going-forward, projected basis rather than through embedded, historical costs. Therefore, we consider Ameritech Illinois' selection of 1997 budgeted data to be reasonable because at the time, calendar year 1997 was a forward-looking time period for which the anticipated cost effects of interconnection and unbundling were reflected in Ameritech's financial planning (budgeting) process. At the same time it does not involve inherently speculative projections for more distant time periods.

The objections to Ameritech's use of budget data, rather than 1996 actual data, which were raised by several witnesses is somewhat curious in light of the fact that we have commonly used future test years in rate cases. The analysis of Ameritech Illinois' common and shared cost allocations does not appear to present radically new complications. As in a rate case, the analysis should focus primarily on whether particular costs are properly recoverable, in this case from a particular subset of telecommunications services We are not persuaded that the use of actual 1996 expenditures is an appropriate forward-looking starting point for this analysis. We also fail to see the advantages which Staff claims. While it is true that use of historical data may avoid a dispute over the quantity of dollars spent, it does little to answer the real question presented - what amounts of shared and common costs are properly assessed to UNEs and interconnection. Thus, disputes about the efficiency of expenditures or propriety of allocations are not minimized simply through the use of historical data. Stated another way, the important questions are not answered if Ameritech Illinois says "we spent 'x' dollars on activity 'y' ", rather than "we plan to spend 'x' dollars on activity 'y'."

We share to a certain extent the concerns expressed by several witnesses that the record contains very little proof of the accuracy of Ameritech Illinois' budgeting process as a predictor of ultimate actual expenditures. However, we are not persuaded that this requires a radical overhaul to the Andersen study or that we disregard it. The fact that the commitment budget actually came in at higher amounts than the preliminary budget suggests that the data relied upon by Andersen was conservative. Moreover, we believe that a successful company would not stay successful very long if it had a vastly inaccurate budgeting process.

We consider the complaints that Andersen did not evaluate the efficiency of the cost numbers to be similarly overstated. There are at least two notions of efficiency. The first relates to waste or extravagance. With respect to this aspect of efficiency we are inclined to agree with Ameritech Illinois that the existence of alternative regulation should be an effective force ensuring the efficiency of expenditures. Alternative regulation, particularly a plan with no limitations on allowed returns, creates in theory, an entirely different set of incentives for a firm than those which exist under traditional regulation. Traditional regulation is often referred to as "cost plus." Under alternative regulation every single dollar of expenditures comes out of the bottom line. In the near future we will be evaluating whether reality matches the theory of and expectations for alternative regulation. With respect to this case, we find it interesting that very few of the proposed adjustments relate to this aspect of efficiency, even though it has been our experience that it is often the first and most obvious objection arising from a review of costs.

The second aspect of efficiency can be called technological efficiency. This relates to the various arguments that the Andersen study did not adequately consider for example , whether "least cost technology" was being used by Ameritech Illinois as it incurs the costs which are the subject of the study. AT&T/MCI correctly note that Section 791.20 (c) of our cost of service rule defines "forward-looking" costs as follows:

> Forward looking costs are the costs to be incurred by a carrier in the provision of a service. These costs shall be calculated as if the service were being provided for the first time and shall reflect planned adjustments in the firm's plant and equipment. Forward-looking costs ignore embedded or historical costs; rather, they are based on the least cost technology currently available whose cost can be reasonably estimated based on available data.

We agree that this passage is consistent with the FCC's approach. It also clearly demonstrates that the concept of forward-looking costs is not new to this Commission. Nevertheless the parties have taken license, as it suited them, to suggest dramatically new methods of calculating costs.

AT&T/MCI provided insufficient evidence to justify an inference that Ameritech Illinois' calculation of shared and common costs did not already adequately reflect the least cost technology currently available. AT&T/MCI never explained how a cost efficiency review could have been conducted based on the data and time available. If there are factors which support the proposition that Ameritech Illinois has overstated its costs, then it would seem appropriate for AT&T/MCI to identify those factors and their purported effects with specificity, rather than simply raise a generic objection to the Andersen study and suggest that it is Ameritech Illinois' burden to somehow affirmatively prove every dollar of costs as efficiently incurred. The implication of AT&T/MCI's arguments is that Ameritech Illinois should have had Andersen evaluate such details as whether it was appropriate, for example, for Ameritech to assign five individuals to a particular UNE-related business unit, rather than some different number of employees, or whether the number of employees might be reduced over time. We do not believe that Congress or the FCC intended that an incumbent LEC be required to commission an independent management audit of its operations before it could recover from UNEs an allocation of its shared and common costs. Legislatures tend to be quite specific about such a requirement as demonstrated in Section 5/9-213 of the Illinois Public Utilities Act. In the absence of such a statutory directive, we will not retroactively impose that requirement, and do not find Ameritech's approach to be fundamentally flawed. To the extent there is some limited anecdotal or opinion evidence in this record that certain unspecified new technologies or practices will yield lower expense to investment ratios (MCI Ex. 2.0 p. 76) or that Ameritech Illinois will experience economies as it gains experience providing UNEs (AI Ex. 6.0 at 26), that would seem a better argument for revisiting the cost issue sometime in the future rather than for disregarding the Andersen study completely.

We reject Dr. Ankum's claim that the NYNEX proceeding to which he alludes in his testimony is reasonable support for the proposition that the Andersen study overestimates the "true" shared and common costs of Ameritech Illinois by at least 20%. We also do not believe that the various general complaints raised by AT&T and MCI regarding the Andersen study warrants an essentially arbitrary blanket reduction to the identified costs. Similarly, if there is any merit in AT&T/MCI's proposal to simply adopt a common and shared cost fixed percentage markup over TELRIC, it is crucially dependent on the validity of the methodology used to develop the suggested markup. It certainly cannot be argued that a fixed markup approach would be more accurate than utilizing the Andersen study. Mr. Behounek's calculation cannot be adopted because he primarily relied upon the adjustments proposed by Dr. Ankum many of which, as discussed below, we do not adopt. Finally, we consider Mr. Henson's formula to be overly simplistic and methodologically suspect.

Nevertheless, based on our review of the evidence we conclude that a number of adjustments should be made to the Andersen study:

With respect to shared costs, Dr. Ankum proposed a number of adjustments to correct for alleged mistakes in assignments of AIIS personnel. Ameritech Illinois' only rebuttal to Dr. Ankum's adjustments was to claim that he used an outdated organizational chart. The evidence in this proceeding is that Dr. Ankum used the organizational chart which was included as part of the AA Study and was the only organizational chart provided by Ameritech Illinois. More importantly, if Dr. Ankum were incorrect in correcting certain assignments of personnel, then it would have been a simple matter for Ameritech Illinois simply to present evidence showing where Dr. Ankum was wrong. Ameritech Illinois presented no such evidence. In fact, Ameritech offered no rebuttal to any of the personnel adjustments proposed by Dr. Ankum. Similarly, Ameritech presented no evidence challenging Dr. Ankum's adjustments removing the salary and benefits associated with employees assigned to wireless, mutual compensation, or long distance services. Nor did Ameritech present any evidence challenging Dr. Ankum's proposal to eliminate "other employee related expenses" (e.g., computer costs) and contract services (carpeting and painting) associated with the same personnel.

Ameritech Illinois' response suggesting that the deposition of Ms. Rotondi in the Ohio proceeding is somehow sufficient to rebut Dr. Ankum's analysis is totally unacceptable. The point of this exercise is to determine the proper amount of costs to be assessed to UNEs, it is not to evaluate Dr. Ankum's analytical process. The parties are advised that we will make an independent evaluation of the evidence which is presented to us, regardless of what may or may not have occurred in another jurisdiction. Our traditional approach has been that when a cost is challenged the appropriate response is to show how and why the cost was properly incurred or allocated. In the absence of that showing we will not permit it to be recovered. Ms. Rotondi's analysis may well be correct, but we have no way of evaluating it.

For Ameritech Illinois, Dr. Ankum suggested a reduction in the assignment of costs equal to 3/15 (since 3 of its 15 employees allocated to UNEs were allegedly improper) which amounts to a reduction of $208,320.00. (MCI Ex. 2.0P, p. 97). For AIIS, Dr. Ankum found that $521,275 of the $2,903,275 or 17.95% in wages from the AIIS business unit was improperly assigned to UNEs. (Id., pp. 97-98). The Commission accepts Dr. Ankum's recommendations.

In addition to the assignment of employee wages, Ameritech also directly assigned to unbundled elements the benefits and "other employee related expenses" associated with these personnel. (MCI Cross Ex. 2P). Since the wage benefits and "other" associated costs are the direct result of assigning personnel to UNEs, the Commission also accepts Dr. Ankum's recommendation that benefits and other associated costs be reduced to match the personnel he contended were improperly assigned to UNEs. Dr. Ankum determined that benefits represent a 26% add-on to wages. MCI Ex. 2.0P, p. 98. Accordingly, he added 26% to the wage adjustment of $521,275 to produce a total adjustment of $657,456. (Id.). Since some 17.95% of AIIS wages were improperly assigned to UNEs, 17.95% of "other" associated costs, or $498,436, should be eliminated entirely from the shared cost pool. (Id., p. 99).

The AIIS Unit also assigned directly to unbundled elements some $1,516,100 for carpeting, painting and other contract services for space for the assigned personnel. Again, inasmuch as 17.95% of those employees' wages were improperly allocated to

UNEs, 17.95% of the costs of painting, carpeting and other space related costs for the assigned personnel should be deleted. This adjustment yields a further reduction of $272,207 from the shared cost pool. (Id). Altogether, the total misallocation of employee-related costs from the AIIS Business Unit to the shared costs pool amounts to $1,291,851.

Finally, the AIIS budget assigned $1,560,734 as a shared cost to unbundled elements for computer related expenses for new employees. (AT&T/MCI Joint Ex. 6.0P, p. 25). The Commission finds that two adjustments should be made to this amount. First, the one-time software expenses should be amortized over two years to reflect the expected economic life of software assets. (AT&T/MCI Joint Ex. 6.0P, p. 24). This reduces the expense to $1,234,784 annually. Second, the Arthur Andersen work papers reveal that these funds are directly related to the purchase of computers and software for all of the new AIIS employees, not just the new AIIS employees who are directly assigned to unbundled elements. (Id). The AA Study work papers further reveal that the increase in personnel for the unbundling segment of AIIS represents 22.47% of the increase in personnel for AIIS as a whole. Thus the unbundling segment should receive 22.47% of these expenses (or $277,404) as shared costs, with the remainder being assigned to the AIIS common cost pool for further allocation.

Ameritech Illinois offers no meaningful challenge to Dr. Ankum's proposals to remove from the shared cost pool and reallocate to the common cost pool $138,454 in Corporate Strategy costs and $299,212 in Public Policy costs. Ameritech Illinois' work papers offer no rationale as to why these costs are assigned exclusively to UNEs, as opposed to being included in the common cost pool. (MCI Ex. 2.0P p.100). Indeed, when presented with evidence showing that the $138,454 of Corporate Strategy costs relates to an employee whose time is devoted to resale and unbundling, Ameritech's only response was to criticize Dr. Ankum for failing to separate the amount of time spent on resale versus unbundling. The responsibility for segregating costs belongs to Ameritech, not MCI or AT&T.

With respect to common costs, the inclusion of over $23 million in expenditures for golf tournaments, skyboxes, and White House functions, is unacceptable. We would not permit the inclusion of these items in rates for retail customers and given the limited justification provided by Ameritech Illinois we see no reason to force purchasers of UNEs to underwrite these activities. With respect to charitable contributions, the Commission notes that Ameritech Illinois' rates for noncompetitive services are regulated under an alternative form of price regulation. Under that plan, rates are not based upon operating expenses. Therefore, notwithstanding Section 9-227 of the Public Utilities Act, Ameritech Illinois' rates no longer include a measurable assessment for corporate charitable contributions. Moreover, we believe that an increasingly competitive environment it would be an inappropriate policy to impose upon new entrants increased costs of doing business which are solely attributable to the discretionary actions of Ameritech and which provide no direct and essential benefit to the UNE purchaser. Notwithstanding this decision, the Commission is confident that

Ameritech will continue to build upon its outstanding record of civic participation and corporate social responsibility.

Ameritech Illinois also fails to offer any challenge to Dr. Ankum's recommendation that other retail-related expenses be eliminated from the common cost pool. These expenses include: 1) $91,533,000 under the listing PROCSOL VG2 related to printing of customer bills; 2) $21,203,000 in expenses related to retail customer account information; 3) $147,007,000 in computer costs to allow Ameritech to bill customers for telephone usage; 4) $17,161,000 for corrections of service orders, toll usage and handling of special customer bills; and 5) $15,607,000 related to the management of remittance of Ameritech customer bill payment. These expenses must therefore be removed from the common cost pool.

We conclude that in its testimony and briefs, Ameritech Illinois sufficiently rebutted the other challenges to the specific costs identified in the Andersen study. We specifically reject the numerous adjustments which Dr. Ankum made to legal expenses and consultant fees. Contrary to contentions that they are "one-time expenses that [will] not re-occur to the same extent" in the future, no one can seriously doubt that, on a forward-looking basis, incumbent LECs will continue to incur substantial recurring legal expenses as a result of their unbundling obligations under the Act. Such expenses will arise from, among other things, (1) additional negotiations with requesting carriers, (2) additional arbitrations with requesting carriers, (3) renegotiation of existing interconnection agreements, (4) complaint cases regarding Ameritech Illinois' performance under such agreements, and (5) cost dockets such as this one regarding unbundled network elements. We also reject Dr. Ankum's contentions that legal expenses arise from "litigation *against* the very new entrants that would purchase unbundled network elements" and that "much of Ameritech's legal maneuvers [sic] and litigation is really aimed at protecting its base of retail customers." The Act, however, requires Ameritech Illinois to participate in such negotiations and arbitrations, which are initiated by competitors, not Ameritech Illinois. We also note that we have always permitted the recovery of such costs in retail rates. Finally, we observe that a number of studies and proceedings arise out of this docket which are unlikely to have been anticipated by Ameritech Illinois.

The Commission concludes that one aspect of Ameritech Illinois' allocation of common costs is unacceptable. The 1995 Ameritech Annual Report identifies a series of non-regulated, retail business activities under the title of "New Ventures." AT&T (Cross Ex. 4). Under Ameritech's allocation system, "New Ventures" improperly receives no allocation of common costs. New Ventures are "non-core" activities. Excluding New Ventures in the allocation process decreased the ratio of "non-core" to "core" activities. If New Ventures were added back, the core/non-core allocator would decrease the amount of common costs eventually allocated to unbundled network elements.

The exclusion of New Ventures means that none of the President of Ameritech's salary, or the real estate costs, or the costs of the Ameritech Institute are allocated to New Ventures, even though all unbundled network elements will bear part of these expenses. Ameritech Illinois is directed to revise its calculations accordingly.

Although the FCC Order does not specify a particular methodology for attributing shared and common costs to UNEs, Andersen's use of cost causative allocators and general allocators based on direct expenses to attribute common costs to AIIS and of extended TELRICs to attribute shared and common costs to individual UNEs is entirely consistent with the FCC's discussion of shared and common costs in ¶¶ 694-698 of the FCC Order. No persuasive objections were raised regarding these aspects of the Andersen study. For example, regarding Mr. Price's claim that shared costs should be allocated to individual UNEs based on cost causation, we agree with Ameritech Illinois that the nature of these costs (e.g, Legal, Public Policy, and AIIS unbundling costs) precludes they be allocated on such a basis. We therefore support Andersen's proportional allocation of these costs among all UNEs.

However, we agree with ATT/MCI that Ameritech Illinois' attribution of the same dollar amount of shared and common costs to individual unbundled loops does not accord with the FCC guideline in ¶ 696 of the FCC Order. Specifically, Ameritech is proposing to charge a fixed price per loop for shared and common costs. According to Ameritech's proposal, a rarely used 4-wire analog loop in rural Illinois (Rate Zone C) will receive the same charge as a 2-wire loop in Chicago (Rate Zone A). The problem with this approach is obvious. It allocates proportionately more costs onto loops in areas where competition is most likely to originate. For example, the percentage mark-up for a basic business loop in Rate Zone A is 4.9 times as large as the percentage mark-up for the same loop in Rate Zone C, and 11.9 times as large as the percentage mark-up for a 4-Wire Analog loop in Rate Zone C. In other words, the lowest cost and most competitive loops carry the highest percentage of shared and common costs.

The FCC at paragraph 696 of its First Report and Order stated the following with respect to allocating shared and common costs:

> We conclude that forward-looking common costs shall be allocated among elements and services in a reasonable manner, consistent with the pro-competitive goals of the 1996 Act. <u>One reasonable allocation method would be to allocate common costs using a fixed allocator, such as a percentage mark-up over the directly attributable forward-looking costs</u>. We conclude that a second reasonable allocation method would allocate only a relatively small share of common costs to certain critical network elements, such as loops and collocation, that are most difficult for entrants to replicate promptly (i.e., bottleneck facilities). On the other hand, certain other allocation methods would not be reasonable. For example, we conclude that an allocation method that relies exclusively on allocating common costs in inverse proportion to the sensitivity of demand

> for various network elements from services may not be used. We conclude that such an allocation could unreasonably limit the extent of entry into local exchange markets by allocating more costs to, and thus raising the price of, most critical bottleneck inputs, the demand for which tends to be relatively inelastic. Such an allocation of these costs would undermine the procompetitive objectives of the 1996 Act. (Emphasis added.)

Thus, the FCC clearly found that using a fixed percentage allocator -- which is what AT&T and MCI are proposing and not what Ameritech is proposing -- is a reasonable method of allocating shared and common costs. Moreover, the Commission rejects Ameritech Illinois' suggestion that MCI's and AT&T's proposals amount to Ramsey pricing. In ¶696, the FCC both adopted a fixed percentage allocator as reasonable and rejected Ramsey pricing. Thus, there is no basis to suggest that a fixed percentage allocator is Ramsey pricing for if they are one and the same, the FCC would not have adopted one and rejected the other.

The methodology used for allocating shared and common costs should be consistent for all network elements. Ameritech Illinois should allocate shared and common costs to unbundled loops based on specific extended TELRIC for each rate zone, A, B, and C, thus developing total costs for each element appropriately, i.e., based on the costs related to the specific element.

We note Dr. Ankum's observation that Ameritech Illinois allocates its shared and common costs across its five state territories using extended TELRICS. This means the larger the Extended TELRIC, the larger the proportionate share of shared and common costs allocated to a given state. This will render the amount of shared and common costs allocated to Illinois dependent on the TELRICs approved in other jurisdictions. We will adopt Ms. Yow's suggestion to require that for purposes of allocation to Illinois, Ameritech Illinois shall use extended TELRICs based on the assumptions approved in Illinois.

Ameritech Illinois is directed to recalculate its rates based on the above adjustments.

D. Non-Volume Sensitive Costs

Ameritech

Ameritech witness Broadhurst testified in his direct testimony that Arthur Andersen, in its analysis and review of Ameritech's TELRIC studies, assigned costs to seven categories. One of these categories was non-volume sensitive costs, which were not included in TELRIC studies of individual UNEs. (AI Ex. 4.0, p. 9). Mr Broadhurst stated later in his testimony that these costs are "relatively minor" and are primarily involved with upfront network planning for the deployment of certain UNEs which had not been included in the TELRIC studies for UNEs. (Id., p. 10). Further, he stated that these costs were added to the amounts derived in the TELRIC studies and were not included again as shared or common costs.

AT&T and MCI

AT&T/MCI identified a number of concerns regarding non-volume sensitive costs. First, AT&T and MCI argued that these non-volume sensitive costs are neither forward-looking nor incremental to the provision of specific unbundled network elements. (AT&T/MCI Joint Initial Brief, p. 139). Many of the activities which make up the non-volume sensitive costs do not vary with the output of UNEs. Consequently, these non-sensitive costs are not incremental to UNEs in an economic sense according to AT&T and MCI. Moreover, these non-volume sensitive costs, which are being used to convert Ameritech Illinois' embedded network, are not forward-looking. AT&T and MCI also objected to the manner in which the non-volume sensitive costs were calculated. (Id., p. 141). MCI witness Ankum alleged that there were nearly $800,000.00 of misallocated expenses. (MCI Ex. 2.0P, pp. 114-115). Dr. Ankum posited that these misallocated expenses are actually associated with resale products and presubscription initiatives.

AT&T and MCI next questioned the manner in which Ameritech Illinois allocates these costs among states and individual UNEs because Ameritech relies on the same arbitrary forecasted demand method as it used in its shared and common cost analysis.

AT&T and MCI contend that Ameritech should be prohibited from recovering the identified non-volume sensitive costs. If these costs are to be recovered at all, however, AT&T and MCI contend they must be recovered in a competitively neutral fashion from all participants in the market place. (AT&T Ex. 1.0P, p. 67; MCI Ex. 3.0, pp. 23-24). This concept of competitively neutral recovery is multi-faceted, AT&T and MCI point out. (AT&T Ex. 1.0, pp. 67-68). First, to the extent that all customers participating in the local exchange market will benefit, or have the potential to benefit, these one-time expenses should be borne by all market place participants. Second, service providers should participate in this cost recovery in a manner that relates to the quantities of elements that are used. Third, to the extent one-time unbundling expenses provide benefits into the future, cost recovery should similarly follow. In other words, carriers entering the market now should not bear the majority of the costs associated with unbundling, thereby allowing later entrants to avoid such costs. Finally, AT&T and MCI recommends that a true-up mechanism should be considered to assure that potentially inaccurate demand forecasts do not lead to an over or under recovery of non-volume sensitive costs.

Staff

Staff witness Price, in his direct testimony, questioned the addition of the non-volume sensitive costs to TELRIC. (Staff Ex. 1.00, p. 13). He noted that the non-volume sensitive costs had been previously questioned by Staff in the arbitration proceedings, and stated that the costs are not incremental and that they should be assigned through TELRIC and not allocated in the same manner as shared and common costs. However, in its Initial Brief, Staff stated that it did not find Intervenors' arguments to exclude non-volume sensitive costs persuasive. Ameritech Illinois has provided information explaining the origin of the cost and, based upon that explanation, Staff recommended that they be included. However Staff still raised concerns with the allocation method used by Ameritech to assign the non-volume sensitive costs to individual TELRICs.

Commission Analysis and Conclusion

The Commission does not find AT&T/MCI's arguments concerning the recovery of these costs to be persuasive. Ameritech Illinois has provided a sufficient explanation for these costs and they should be recovered. Mr. Broadhurst identified the specific activities included in the NVS costs, and some that were excluded because Ameritech Illinois had already included the cost in the TELRIC studies. Costs associated with resale and presubscription were properly excluded from the Andersen study and form no part of NVS costs. (AI Ex. 4.1 p. 34-35).

However, we agree with Staff that the costs should not be allocated in the same manner used for allocating shared and common costs. We shall accept Ameritech Illinois' 3 year amortization of the NVS costs, but they should be specifically assigned to the TELRICs with which they should be associated rather than an assignment based on extended TELRIC. In addition the tariff rate for these NVS costs should be eliminated after the 3 year period has expired.

E. Local Switching Prices

Position of Ameritech Illinois

Ameritech Illinois contends that its switch-based cost studies, which cover ULS, unbundled tandem switching, OS/DA, daily usage feed, and the recurring charge for network access/service coordination, employ the same basic methodology as in prior LRSIC studies that the Commission has approved. The company relied on several Bellcore cost models, including the Switching Cost Information System ("SCIS") and Common Channel Signaling Cost Information System ("CCSCIS"). The developed switch costs reflect only forward-looking digital switch types. SCIS analyzes and calculates unit investments for central office functions and features based on information provided by switch vendors. CCSCIS develops investments in the SS7 network that is used both to establish connections for various types of calls and to provide Advanced Intelligent Network ("AIN") services. CCSCIS outputs are used with SCIS to calculate investments for AIN services, and CCSCIS calculates costs for signal transfer points ("STP"), signal control points ("SCP") and SS7 links. The specific CCSCIS models are based on input from Ameritech's vendors for STPs, SCPs and SS7 links. Ameritech submits that its reliance on these advanced models enabled the company to develop cost studies that reflect a forward-looking, best available technology network and perspective.

Ameritech Illinois also made an adjustment to its ULS costs to account for excess CCS capacity, required due to the inability to match precisely the capacities of equipment available from vendors with actual usage.

Ameritech Illinois objects to proposals for a flat-rate switching charge contending that some switch-related costs are traffic-sensitive and usage related and therefore should be recovered through a usage charge. For example, the key driver used to engineer line interfaces on a digital switch is usage, and different levels of usage in each switching system require different quantities of line interface equipment.

Ameritech Illinois also expressed concerns that a flat-rate charge for local switching would lead to inefficient use of the switch. It notes that America Online's recent implementation of flat rate charges proved disastrous.

WorldCom

WorldCom witness Gillan, testifying on behalf of WorldCom, addresses cost studies applicable to network elements. He argues that the SCIS costing model used by Ameritech addresses switching costs in a manner inconsistent with the definition of an unbundled local switching (ULS) network element as the per-line provision of switch capacity to an entrant. Mr. Gillan states that SCIS attributes switch costs between line and usage factors in a way which systematically inflates the usage component, and that SCIS's service-driven focus on usage is not appropriate to the costing of switching capacity. (WorldCom Exhibit 1.0, pp. 3-4).

Mr. Gillan further states that SCIS may not be appropriate for determining the cost of the unbundled local switching (ULS) network element and that a per-line rate structure may more closely reflect how the costs of the ULS network elements are actually incurred. His reasoning is that the ULS network element is the purchase of all the functionality of a switch, and as such Ameritech's cost for the switch is based on a price per line, not on usage. For this per-line charge, Ameritech obtains a switch that performs to its specifications in terms of features, functions and capacity. The ULS purchaser obtains access to this same set of features, functions and capabilities for each line of capacity that it purchases. Mr. Gillan's conclusion is that the ULS charge to Competitive Local Exchange Carriers (CLEC) should parallel Ameritech's cost, using as the rating basis a per-line charge, the basis used in Ameritech's contracts with its vendors. (WorldCom Exhibit No. 1.3, pp. 20-21).

Based on a review of Ameritech's switching contracts, it is clear that the primary basis used by switch vendors to charge Ameritech for their switches is a price per line. (Id., p. 21). Despite the fact that firm price proposals were submitted by these vendors to Ameritech in the third quarter of 1996 and the contracts were executed and effective shortly thereafter, Ameritech conveniently did not include those contracts in its switching study in its initial round of testimony, its March 31, 1997 rebuttal testimony or its May 2, 1997 surrebuttal testimony. (Tr. 525-531).

WorldCom notes that Mr. Palmer indicated in his rebuttal testimony that Ameritech's decision to propose a flat rate and a usage rate for the ULS element is a pricing decision, and does not necessarily reflect the rate structure of Ameritech's switch vendors.

AT&T/MCI

MCI witness Ankum contended that Ameritech Illinois' ULS cost studies ignored the difference between host and remote switches in the company's network. He also objected to the excess CCS capacity adjustment made by Ameritech Illinois, primarily because it results in lower network utilization that shown in Ameritech Illinois' ACAR manual.

AT&T and MCI in reliance upon Mr. Gillan's testimony also criticize Ameritech's proposed tariff because it includes both per-line and usage rates for the pricing of the ULS element, including a flat rate for the line port, a flat rate for the trunk port and volume-sensitive usage.

Because Ameritech incurs switching costs on a predominantly per-line basis, AT&T and MCI contend that it is consistent with the fundamental principles of cost causation that the ULS subscriber should also pay for the ULS element on a per line basis, without a usage charge. (MCI Ex. 2.2P at 53-54).

Therefore, consistent with the above, they recommend that Ameritech be required to file, within 30 days of the Commission's Order, a new ULS price structure on a per-line basis which accurately reflects the contract prices of Ameritech's principal switch vendors, along with an analysis demonstrating that this calculation reasonably estimates the actual, per-line cost of switching. In the interim, they propose that the Commission adopt the interim ULS rate of $5.01 per-line per-month as calculated by Mr. Gillan (incorporating various modifications as recommended by AT&T witness Webber) in WorldCom Ex. 1.3P, Sch 3P.

Position of Staff

Staff agreed with WorldCom in part, contending that a flat monthly switching charge would be appropriate for much of the local switching element.

Commission Analysis and Conclusion

We reject AT&T/MCI's objection to Ameritech Illinois' CCS capacity adjustment in developing its local switching costs. Their reliance on ACAR is inappropriate because ACAR was developed for the retail LRSIC studies and does not address how to apply the proper CCS capacity adjustment. CCS-related costs are necessarily incurred in any forward-looking unbundled switch design. Mr. Palmer explained that the adjustment is necessary to capture the differences between engineered and available capacity. Because these costs are caused by the provision of unbundled line-side ports to new entrants, the CCS capacity adjustment was properly applied to those unbundled ports.

Dr. Ankum erroneously charged that the ULS cost studies ignored the difference between host and remote switches in Ameritech Illinois' network. In fact, Mr. Palmer explained that those studies utilized the existing mix of host and remote (as well as stand-alone) switches.

Ameritech's proposed tariff includes a combination of per-line and usage rates for the pricing of the ULS element, including a flat rate for the line port, a flat rate for the trunk port and volume sensitive usage. The individual portions of Ameritech's switch pricing proposal were developed through the use of the SCIS Model. Ameritech's own testimony reveals that SCIS overstates the usage-cost of local switching and produces results intended to support Ameritech's pricing structure and objectives, not its underlying costs. Based on a review of Ameritech's switching contracts, it is clear that the primary basis used by switch vendors to charge Ameritech for its switches is a price per line. Because Ameritech incurs switching costs on a predominantly per-line basis, we find it consistent with the fundamental principles of cost causation that the ULS subscriber should also pay the ULS element primarily on a per line basis, without a usage charge. However, as Staff noted, this does not totally preclude a minimal per-minute charge each time a particular line is accessed in order for Ameritech Illinois to recover actual costs incurred whenever the switch is activated.

We fail to understand Ameritech Illinois' internet analogy since it is unclear how flat rates for other carriers, as opposed to the end-user, will result in inefficiencies.

Therefore, we require Ameritech to file a new ULS cost study which establishes prices primarily based on the flat-rate terms of its vendor contracts. The cost study should delineate the usage costs incurred whenever a portion of the switch is activated, and Ameritech Illinois should be allowed to recover this incremental cost from the CLEC, either as a portion of the per-line charge, or through a small charge per minute of use. The usage charge should not recover any costs associated with the initial cost of the switch, but only those usage-sensitive costs necessary to operate and maintain the switch. Ameritech Illinois' study should be filed within 30 days of the entry of this Order. Tariffs reflecting Ameritech Illinois' costs should be filed 15 days thereafter. In the interim, the Commission adopts the interim ULS rate of $5.01 per line per month as calculated by WorldCom witness Mr. Gillan in WorldCom Ex. 1.3P, Sch. 3P.

F. *Call Termination Charges*

Position of Ameritech

Ameritech Illinois proposes that carriers pay $.005 for each call terminated on the other carrier's network. Ameritech Illinois argues that this charge is based upon its cost studies, which use the long-established NCAT model which uses inputs which represent all of Ameritech Illinois' central offices as well as the trunking network.

Position of TCG

TCG recommended that Ameritech Illinois set a call termination charge based on the number of lines connected to the other carrier's network. TCG argued that the value of providing a price signal by charging on a per call basis is outweighed by the cost of measuring those calls. TCG stated that the costs of measuring these local call terminations are not very different from the TELRIC of the actual function itself. TCG witness Montgomery thus characterized these measurement costs as a deadweight economic loss. He said that Ameritech Illinois' measurement and billing cost was in excess of half of the lower limit of the FCC's default cost of a local call termination of 0.2 cents. (TCG Ex. 1, p. 25). TCG argues that insisting upon measuring each call is economic waste that creates a barrier to competition. It maintains that flat rate charges often are the best reflection of costs in telecommunications networks because network costs are incurred on a capacity basis rather than a usage sensitive basis. (TCG Ex. 3, p. 8-9).

Commission Analysis and Conclusion

We will not at this time require the development of a flat rate termination charge as proposed by TCG witness Montgomery. Ameritech Illinois' use of the long established NCAT model uses inputs which include central offices and the trunking network. TCG did not present sufficient evidence to allay our concern that a non usage based mechanism could conflict with the Act's requirement in ¶ 252(d)(2)(A), that rates recover the "additional costs" associated with terminating calls.

G. *Poles and Conduit*

Position of Ameritech Illinois

Ameritech Illinois based its cost study for poles, ducts, and conduit on the FCC's prescribed formula for rate development in Docket No. 96-181, in which the FCC addressed calculation of total and usable duct space, occupied conduit, and administrative, depreciation, maintenance, and tax expenses, and Docket No. 86-212, in which the FCC addressed pole attachment rates. Ameritech Illinois' proposed rates do not vary significantly from the existing tariffed rates.

Position of Intervenors

MCI witness Ankum contended that pole investments are non-volume sensitive costs that should be allocated among all users of those facilities.

Commission Analysis and Conclusion

Ameritech Illinois' proposed rates fully comply with the FCC's prescribed methodology for poles, ducts and conduit. No party has raised any persuasive basis for the Commission to depart from the methodology adopted by the FCC and applied by Ameritech Illinois.

Dr. Ankum's proposal to allocate pole investments among all users of those facilities confuses cost recovery with cost causation. As discussed by Mr. Palmer, Ameritech Illinois' pole investment costs are volume-sensitive, derived by dividing its pole investments by its investment in aerial cable and assigning a proportionate share of pole expenses to all services using aerial cable on a per foot basis. This approach properly assigns costs to those responsible for causing them. In any event, as Mr. Palmer demonstrated, an adjustment in Ameritech Illinois' pole factor by the net revenue received from other companies would lead to only a de minimis decrease in loop costs of a few cents.

H.. Recovery of "Residual"

Position of Ameritech Illinois

In the event that the FCC Order is reversed, Ameritech Illinois supports the inclusion of an allocation of its "residual costs" in the rates established for UNEs, interconnection, transport and termination services. Ameritech Illinois took the position that Sections 252(d)(1) and (2) do not specify any particular definition of costs for UNEs and interconnection, thereby giving the Commission the flexibility to include the recovery of residual costs. Further, Ameritech Illinois noted that the FCC, in rejecting residual cost recovery, did not do so on a legal basis, but rather on a policy basis, citing ¶ 705 of the FCC Order.

Ameritech Illinois defines the residual ("1994 capped residual") as the gap between its forward looking costs (TELRIC, shared and common costs) and its overall 1994 revenues. (AI Ex. 1.0 at 33 and 40). Mr. Gebhardt testified that the 1994 capped residual includes costs related to capacities deployed but not fully utilized, capital costs of common assets, and the cost of any incompletely depreciated assets whose economic lives have ended. (AI Ex. 6.0 at 34). Finally, he acknowledged that the residual may include excess profit. (Staff Ex. 3.00, Attachment 1 and Tr. 119 at lines 11-16).

Ameritech Illinois proposes to allocate its 1994 capped residual to UNEs, interconnection, transport and termination services using one of two alternatives. The first alternative would allocate the 1994 capped residual using the relative extended TELRIC method. (AI Ex. 1.0 at 40). The second alternative would allocate the 1994 capped residual using a fixed markup of about 20% over the TELRIC for each item. (Id. at 43 and AI Ex. 1.1 at 20-21).

Ameritech Illinois recognizes that contribution from its payphone CPE would need to be removed from the residual. (AI Ex. 1.2 at 7 and Tr. 164 at lines 9-12). Ameritech Illinois also recognizes that contribution from access charges may need to be removed from its residual. (Tr. 98 line 19 to Tr. 99 line 1, Tr. 102 line 17 to Tr. 103 line 3 and Tr. 165 lines 12-16).

Although Ameritech Illinois does not propose a mechanism to phase out the residual as it is recovered, Mr. Gebhardt stated, during cross examination, that it would be appropriate to adjust the residual downward over time to the extent that any under-depreciated plant and equipment, included in the residual is fully depreciated using Ameritech Illinois' accelerated depreciation schedules. Mr. Gebhardt added that once the residual is recovered, the percentage markup on each UNE may need to be reduced. (Tr. 166 line 6 to Tr. 167 line 18, and Tr. 221 line 9 to Tr. 222 line 17).

Mr. Gebhardt further testified that the Commission's decision in the wholesale proceeding recognized the importance of residual costs by adopting a pro rata methodology which allocates such costs, including common costs and residual costs. He said that recovery of the residual costs is important to maintain any semblance of a rational relationship between the prices set for wholesale services in the wholesale proceeding (Docket 95-0458) and prices that will be set in the current proceeding. Mr. Gebhardt and Dr. Aron testified that it is extremely important to maintain some sort of rational relationship to prevent "sham unbundling", where carriers would be able to purchase wholesale services at sub-wholesale rates through the purchase of end-to-end, unbundled network elements.

Ameritech Illinois argues that recovery of its 1994 capped residual is appropriate during the transition from a regulatory environment to competition (AI Ex. 6.0 at 35). It says that regulated firms such as Ameritech Illinois were originally in a position of under-depreciating assets precisely because of regulatory mandate. To preclude recovery of those costs now that the regulatory regime is overturned is to renege on the regulatory commitment. (Id. at 35). Ameritech Illinois states that residual costs are costs that were incurred to build Ameritech Illinois' infrastructure, from which entrants and their customers are benefiting when entrants lease UNEs. (AI Ex. 6.1 at 30-31). It also maintains that the Commission's Aggregate Revenue Test also recognizes the residual as containing a legitimate cost which must be allocated between non-competitive and competitive services

Position of Staff

In analyzing the "cost" standard set forth in section 252(d)(1) of the federal Act, Staff concludes that the rate for interconnection and UNEs should be based on forward looking costs since this would discourage inefficient entry into the market and more closely mirror rates that would be developed in a competitive market. However, Staff also concludes that such rates should include a pro-rata adjusted portion of Ameritech Illinois' residual costs, to the extent residual costs exist. (Staff Ex. 2.0 at 12-14 and Staff Ex. 3.0 at 8).

However, Staff concludes that residual costs should not be included in the rates established for transport and termination since they are, by their very nature, remnants of the past. In a long term environment, the size of the residual should change over time due to changes in the remaining depreciation rates of undepreciated assets. However, the residual will not be affected by the change in the volume of transported or terminated calls. As a result, residual costs cannot be considered "additional costs" under the purview of section 252(d)(2) except to the extent that the residual reflects excess capacity costs and common, capital costs of transport and termination. (Id. at 9).

Staff argues that Ameritech Illinois enjoys significant economies of scale that are the product of investments in the network infrastructure over time that will benefit new entrants. Accordingly, it is equitable for new entrants purchasing UNEs to contribute some share towards Ameritech Illinois' residual cost. Staff further contends that new entrants purchasing Ameritech Illinois' UNEs will only have a limited risk of stranded investment. This is because, if a new entrant is unable to generate sufficient demand to recover the cost of the purchased network elements, it can reduce the number of purchased elements or exit the market at little cost to itself. This in turn significantly reduces the barriers to entry and exit in the local exchange market. (Staff Ex. 3.02 at 5). Finally, it is reasonable to compensate Ameritech Illinois for its cost of providing and maintaining its UNEs, on the basis of actual costs if they are higher than forward looking costs. Without compensating it for an adjusted pro-rata portion of its residual, Ameritech Illinois will have reduced incentive to continue investing and upgrading its network because it has no opportunity to recover such costs in an environment of mandated unbundling and possibly declining forward looking costs. This outcome is not in the public interest. (Staff Ex. 3.02 at 5).

While Staff supports allocation of the residual, it does not support doing so on the basis of 1994 revenues. Staff contends that these revenues could contain excess profits. This is because alternative regulation allows Ameritech Illinois to retain most excess earnings resulting from increases in productivity above historical levels. As a result, a portion of the residual, although it did not start as economic profit (because it was based on an acceptable rate of return) may now include excess profit (economic profit). (Staff Ex. 3.00 at 18-19). Accordingly, Staff argues that Ameritech Illinois' 1992 revenue requirement should be utilized. Staff also recommends that Ameritech Illinois' 1992 revenue requirement be adjusted by the change in the price cap index

("PCI") between 1994 and 1997. (Staff Ex. 3.02 at 6). This treatment is appropriate because the change in the PCI reflects the overall cost changes experienced by Ameritech Illinois in providing service. (Id. at 7). Ameritech Illinois' 1992 revenue requirement, as approved by the Commission in Docket 92-0448/93-0239, was $2.047 billion. Adjusting that figure by the change in the PCI between 1994 and 1997 would lead to a revenue requirement of $1.913 billion for purposes of estimating the residual. (Staff Ex. 3.03 at 2).

Staff concludes that the appropriate measure of cost for calculating the residual should represent Ameritech Illinois' TELRIC, shared and common costs, using the assumptions that are approved by the Commission in this proceeding for purposes of calculating TELRIC. This measure of forward looking cost should be subtracted from the revenue requirement ($1.913 billion) calculated above using Staff's proposed adjustments. (Id. at 3).

Staff notes that a portion of the incumbent LEC's residual may have occurred over time as a result of the under depreciation of assets and required network investments. Further, a portion may exist because past costs were higher than forward looking costs. (Staff Ex. 3.00 at 18).

In response, Ameritech Illinois disagrees with Staff's proposal to adjust the 1992 revenue requirement by the change in the PCI between 1994 and 1997. Ameritech Illinois argues that the PCI does not reflect Ameritech Illinois' cost changes completely because it includes a significant consumer dividend factor, a large input differential which is not guaranteed to continue and a service quality component that is unrelated to Ameritech Illinois costs. Ameritech Illinois also contends that Staff is mistaken in concluding that Ameritech Illinois' 1994 revenues contain excess profits. Ameritech Illinois points out that the Commission used the very same 1994 revenues in the wholesale proceeding after engaging in an exhaustive analysis of Ameritech Illinois' costs in that proceeding. No party in that proceeding argued that excess profits were being allocated by virtue of the wholesale pro rata methodology, and Ameritech Illinois does not believe the Commission should credit such arguments in this proceeding. Ameritech Illinois also opposes Staff's proposal that the residual allocation be reduced by changes to the price cap index component of Ameritech Illinois' price cap plan, because such a reduction assumes that Ameritech Illinois' overall costs are decreasing and the opposite is probably true, because demand for Ameritech Illinois' services has been growing, not decreasing, thereby resulting in an increase in volume sensitive costs.

Ameritech Illinois also contends that Staff's methodology of removing retail costs from the residual results in the double removal of such costs. This is because Staff recommends that Ameritech Illinois first allocate a portion of the residual to its retailing cost, and then in addition, allocate a pro rata portion of the residual to the rates charge for UNEs, thereby also removing retailing costs attributable to the residual.

Ameritech Illinois also responded to Staff's contention that only a limited portion of the residual should be allocated to transport and termination services. Ameritech Illinois argues that a full, pro rata share should be allocated, because transport and termination rates should recover the costs associated with providing that service, citing Section 252(d)(2) of the Act. Ameritech Illinois maintains that the residual includes excess capacity, not included in the TELRIC for transport and termination services, which constitutes an "additional cost" resulting from transport and termination. Ameritech Illinois also notes that the residual contains capital costs associated with common costs which also constitute "additional costs" pursuant to section 252(d)(2). Finally, Ameritech Illinois argues that all residual costs are additional costs when demand shifts occur from services to network elements. Therefore, residual costs should be thought of as shifting to the network elements where cost recovery can occur. (Ameritech Illinois Ex. 1.1 at p. 13).

In reply, Staff disagrees with Ameritech Illinois' contentions regarding the consumer dividend factor in the PCI. Unlike rate of return regulation, price cap regulation provides an incumbent LEC with significant incentives to increase efficiency. This is because price cap regulation allows Ameritech Illinois to retain all excess earnings resulting from productivity enhancements over historical productivity levels. The consumer dividend component in the PCI was adopted to ensure that ratepayers benefited from any improvements beyond Ameritech Illinois' historical productivity levels, and to provide Ameritech Illinois with an added productivity incentive. Staff believes the PCI can be viewed as a proxy for Ameritech Illinois' increased efficiency and lower costs during the life of the price cap plan. (Staff Ex. 3.02 at 36).

Staff also disagrees with Ameritech Illinois' contention that the service quality component of the PCI does not reflect cost changes to Ameritech Illinois. In its Order in Docket 92-0448/93-0239, the Commission adopted a service quality component in order to encourage Ameritech Illinois to comply with eight distinct service qualify standards. It functions to penalize Ameritech Illinois by .25% in additional rate reductions for each service quality standard that is missed. (ICC Order in Docket 92-0448/93-0239 at 58-59). To the extent Ameritech Illinois fails these service quality standards and incurs service quality penalties because it has eliminated operator assistance and maintenance positions, or streamlined its operator assistance procedures to minimize cost, the service quality component of the PCI does reflect reductions in Ameritech Illinois' costs. (Tr. 1939 lines 6-8). With regard to Ameritech Illinois' characterization of the consumer dividend as significant, Staff is of the opinion that issues relating to the magnitude and reasonableness of the consumer dividend within Ameritech Illinois' PCI formula are more appropriately addressed in Ameritech Illinois' five year price cap review in 1998. With regard to the input price differential component of the PCI, Staff notes that it reflects Ameritech Illinois' past experience with input prices. As a result, it reflects changes in Ameritech Illinois' costs of providing telecommunications services. To the extent Ameritech Illinois feels that past experiences with input prices are not guaranteed to continue, such concerns are appropriately addressed during the five year price cap review proceeding in 1998. (Staff Ex. 3.02 at 36).

With regard to Ameritech Illinois' excess capacity argument, Staff has no objection to the use of a reasonable projection of anticipated network usage for the purpose of pricing transport and termination. Staff agrees with Ameritech Illinois that excess capacity associated with transport and termination constitutes "additional cost" pursuant to section 252(d)(2). However, it would only be the portion of excess capacity associated with the difference between target network fill (utilized by Ameritech Illinois to develop its TELRICs for transport and termination services) and the reasonable projection of anticipated network usage and not excess capacity related with the difference between target network fill and current actual fill. Further, Staff agrees with Ameritech Illinois that capital costs associated with common costs constitute "additional cost" pursuant to section 252(d)(2). (Staff Ex. 3.02 at 17-18). Therefore, to the extent Ameritech Illinois quantifies the effect of these two items in its residual, the specified quantity should be allocated across all transport and termination minutes. Staff points out however that Ameritech Illinois has not quantified these portions of the residual in this proceeding. (Id. at 18).

With regard to retailing costs, Staff responds that Ameritech Illinois appears to be rearguing the Commission's decision regarding "avoided" vs. "avoidable" retailing costs. The issue is not whether Ameritech Illinois will actually experience retailing cost savings as a result of providing UNEs. The issue is whether such retailing costs would be incurred if Ameritech Illinois were to exit the retail market and provide only wholesale type services and UNEs. In the wholesale proceeding, the Commission found that Ameritech Illinois would avoid retailing costs if it exited the retailing market. The Commission also concluded that a portion of the residual is attributable to Ameritech Illinois' retailing functions, and as such should be removed from contribution prior to its allocation among wholesale services. Staff's recommendation in this proceeding is fully consistent with the Commission's approach. (Id. at 19). Staff also notes that attributing a portion of the residual to retailing functions provides a better proxy for the "costs" as associated with providing UNE and interconnection services as specified in section 252(d)(1) of the federal Act. This is because such costs represent the costs of providing Ameritech Illinois' network to carrier customers on a wholesale basis.

Staff also maintains that there is evidence in this proceeding that there are retailing costs in the residual. For example, both Mr. Gebhardt and Dr. Aron have testified in this proceeding that the residual includes the capital costs associated with common costs. (Ameritech Illinois Ex. 1.1 at 17 and Ameritech Illinois Ex. 6.0 at 31). Since a portion of common costs constitutes retailing costs, surely the capital costs associated with these retailing common costs should be removed from the portion of the residual allocated to UNEs and interconnection services. (Staff Ex. 3.02 at 19-20). Finally, if a portion of the residual is not allocated to retailing functions, Ameritech Illinois' wholesale operation will provide it with more contribution towards the residual